West Bank/Gaza's Economic Prospects and Challenges[1]
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Politics has trumped economics for the West Bank and Gaza in recent years. In cooperation with the IMF, World Bank, and bilateral donors, the Palestinian Authority (PA) has implemented a number of positive economic reforms since its establishment in 2004, reducing its budget imbalance and channeling expenditure in more productive directions. Yet the highly unfavorable political environment in which the West Bank/Gaza economy has had to operate has far outweighed the favorable effects of these reforms and led to declining living standards and massive levels of unemployment and poverty. The Israeli closure regime, which has been in effect since 2000 and has been accompanied by expansion of West Bank settlements, has severely restricted movements of goods, labor, and capital. The election of a Hamas government in Gaza (in opposition to Fatah, which controls the West Bank) and break-up of the national unity government in 2007 undermined the PA's authority in Gaza. Finally, Israel's invasion of Gaza in January 2009, provoked by Hamas attacks on southern Israel, devastated the economy and population in that region.

The Palestinian Reform and Development Plan (PRDP), published in December 2007, aimed at consolidating public finances and stimulating economic growth. The PA gets revenue transfers from Israel (with interruptions that have been made up for by donor aid). The reforms, which furthered financial accountability and fiscal reform, have been implemented largely as planned but the outcome for the economy has been economic decline rather than the growth that was hoped for. The PRDP envisaged gradual relaxation of the Government of Israel's (GOI's) restrictions on movement and access during 2008 to enable a recovery of trade and private investment and an acceleration of public investment. These restrictions were in fact tightened in 2008 because of Israeli security concerns. Even after the cessation of hostilities in Gaza in mid-January 2009, restrictions on the passage of goods and people across Gaza's primary crossings remained tight.

The IMF has stated repeatedly that close cooperation among the PA, the GOI, and donors is critical to the success of the PA's medium-term growth strategy. They have said that while going forward presents some risks for each party, the alternative of not moving ahead implies a continued downward spiral for the West Bank/Gaza economy, which would ultimately be costly to both the West Bank/Gaza and Israel. Notwithstanding recent the war in Gaza, the world community still hopes that the three parties will do their best to fulfill the commitments to sustainable growth and development in the Palestinian territories that they made at the 2007 Annapolis and Paris conferences.

In 2008 the PA made substantial progress in establishing security in several Palestinian cities in the West Bank by deploying police and security forces. This brought about a measure of stability and business confidence. The PA continued with fiscal consolidation by following a restricted government hiring program (only a small number of jobs in education and

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health were created) and a virtual wage freeze, as well as measures to reestablish payment discipline for utility services. The PA's adherence to the budget's ceiling for expenditure commitments, despite the effects of higher-than-anticipated inflation, led to significant retrenchment in real terms.

Inflation flared in early 2008 but has eased somewhat since then. Fanned by rises in world food and petroleum prices, the rate of inflation reached 12% in the year to July 2008. The impact of inflation was greater in West Bank/Gaza than in Israel because at the lower income level prevailing there wheat and other staple foods carry a heavier weight in the consumption basket. The sharp appreciation of the Israeli shekel (which along with the Jordanian dinar serves as the local currency) against the US dollar further impacted incomes in West Bank/Gaza because of the importance of dollar-denominated income sources, such as worker remittances and foreign assistance. For 2008 as a whole, the rate of inflation was 9.9%.

Economic performance remained weak in 2008 as restrictions on movement and access were tightened in the West Bank and Gaza remained isolated. The impact on economic activity was exacerbated by a surge of inflation and the appreciation of the shekel. Although the IMF has estimated that real GDP grew by 2% in 2008 (which implied a decline of 1.2% in real GDP per capita), other data suggest a continued decline in real GDP. The Gaza economy was deteriorating before the invasion, more than offsetting any growth that may have occurred in the West Bank. Economic decline or negligible growth combined with rapid population growth over several years has reduced real GDP per head to a level one-third lower than it was in 1999, before the second intifada.

A revised macroeconomic framework for the West Bank and Gaza is predicated on active pursuit of the peace process and support for growth-enhancing reforms and institution building by the PA, GOI, and donors. Notwithstanding the global slowdown, it envisages an improved business environment (both with the rest of the world and within West Bank/Gaza) as a result of easing of the blockade on Gaza and of restriction on movement and access in the West Bank. These measures could counter the influence of the global recession and aid the recovery of private trade and investment, acceleration of the public investment program, and reconstruction and rehabilitation in Gaza. Under this scenario, real GDP could increase by 5% in 2009, 6.5% in 2010, and 7.5% in 2011. Even if Israel began to loosen restrictions in 2009, however, real income per capita would be about 27% lower in 2011 than it was before the institution of the closure regime in 2000. The rate of unemployment would remain high at 23%, compared to 11% in 2000.

These projections are subject to the significant risk that the peace process will remain stalled and the blockade of Gaza and Israeli restrictions in the West Bank will continue. If this happens, trade, private investment, and donor-financed public investment and reconstruction projects will be hindered. Under these circumstances, slower revenue growth, combined with rising social and emergency spending, could substantially slow the pace of fiscal consolidation, even if the PA maintains strict control of government wages and employment. In this case, real GDP per capita is likely to continue declining and unemployment will rise, probably to over 30% of the labor force by 2011. The risk of social upheaval will increase, which will work against private sector growth and make it harder to restrain public sector wages and employment.

Unemployment and poverty remain very high, especially in Gaza. The measured unemployment rate in Gaza in 2008 was 40%, while the rate in the West Bank was 19%, up from averages of 30% and 18% respectively in 2007. Further increases in these rates have undoubtedly occurred in 2009. If those who had given up on a search for employment were included, the unemployment rates would have been higher still. Restrictions on the ability of Palestinians to work in Israel have been a significant factor in the rise of unemployment. In large part because of the extreme difficulty in finding remunerative employment, poverty is widespread. The Palestinian Expenditure and Consumption Survey of 2007 found that 80% of households in Gaza and 45% in the West Bank were living below the poverty line. These numbers are also likely to have risen since more recently with the tightening of restrictions.

The draft 2009 budget is characterized by a continued reduction in the recurrent deficit and a shift in expenditure away from wages and subsidies and toward nonwage and capital spending. Its key features are containment of the wage bill (by providing a maximum wage increase of 4%, the first since 2005, and an employment freeze except for 3,000 net new hires, mostly in health and education), measures to phase out utility subsidies, slow growth in nonwage expenditures, and a rise in the share of development spending. The draft budget was prepared before the outbreak of war in Gaza. A preliminary estimate of reconstruction and rehabilitation expenditure in Gaza totaled at least $600 million.

To ensure that fiscal adjustment is sustained, structural reforms set out in the PRDP will need to be stepped up in 2009. The IMF is urging public sector retrenchment as a means of sustaining fiscal balance. It also calls for improved collection of utility bills, an improved social safety net for the poor, and comprehensive reform of the public pension system.

Monetary and banking reforms have proceeded with IMF assistance. In spite of the difficult environment, the Palestinians have managed to establish a financial sector composed of most of the expected sub-sectors: banks, a securities market, insurance companies, payments system, housing finance companies, microfinance institutions and financial leasing companies. Yet important needs for financial services have not been met, (for micro-credit, households and SMEs). The Palestinian Monetary Authority (PMA) has engaged in institutional development with an eye to one day becoming a full-fledged central bank with its own currency. This has involved strengthening the supervisory system and governance, establishing a credit registry (which became fully operational in April 2008), and improving the financial legal framework. An Anti Money Laundering Law has been in force since 2007 and a new Banking Law and Central Bank Law are anticipated in 2009.

The PA and the Hamas government in Gaza have developed separate plans for Gaza reconstruction. The PA has received substantial offers of international support for its plan while the Hamas plan has not. Donors pledged $4.5 billion for Gaza reconstruction at a conference hosted by Egypt in March 2009. But little reconstruction work has been done yet because of continuing conflict between the Fatah-controlled PA and also because Gaza remains blockaded despite international calls to lift the blockade. Israel continues to restrict access to Gaza and bars the entry of cement, steel, glass, and other construction materials. Gaza's economy is in ruins and will not recover without a political solution, a guarantee that its borders will remain open to trade, and massive investment. The latest estimate of the cost of the war to the economy of Gaza is $1.9 billion. Reportedly, 80% of Gaza's crops were destroyed.

The United States is the largest bilateral donor to the West Bank and Gaza, having provided $2.3 billion through USAID since 1994. U.S. assistance is intended to promote business and agricultural development, support road, water, and school construction, provide health services, promote democracy, further Israeli-Palestinian economic cooperation, and respond to humanitarian needs. At the March 2009 donors' conference the US announced its intention to commit $900 million to support the PA and Gaza recovery, subject to Congressional approval. Of this total, $300 million is to be spent in Gaza in cooperation with UN agencies, international organizations, USAID grantees, and other humanitarian organizations. Another $200 million will address the PA's anticipated $1.15 billion budget shortfall for 2009, while the remaining $400 million will be spent in support of priorities identified in the PRDP.

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